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SUBJECT: UKRAINE'S PENSION SYSTEM: A TICKING TIME BOMB
APPROACHING ZERO?

REFS: A) KYIV 256
B) KYIV 228

¶1. Summary: Ukraine's financially-unsustainable pay-as-you-go pension system is a leading contributor to the GOU's current budget crisis. A special payroll tax is meant to finance this pension system, but, despite excessively burdensome tax rates, every year the government must pay more and more for pensions through regular budget revenues. The only immediate alternatives are to permit inflation to erode the real value of pensions or to fall into arrears. The Tymoshenko government exacerbated problems by significantly increasing pension payouts in recent years. The GOU is planning some changes to the system, like raising the retirement age, in order to economize, but such measures are unlikely to save what is essentially a sinking ship. Efforts at long-term reform, to include a mandatory accumulation system that would ease pressure on the pay-as-you-go program, as well as voluntary private pension funds, have been halfhearted. And while the budget crisis has awakened some political actors to the need for reform, unfortunately it will also delay the government's ability to actually implement the reforms. End Summary.

The Basic Pension System: Pay-As-You-Go...

¶2. Ukraine's pension system has traditionally operated as a pay-as-you-go program whereby contributions of today's workers fund today's pensioners. Retirement payouts are primarily determined by the individual's labor records and contributions, using a formula -- known as the "accrual rate" -- based the employee's average wage during the last five years of work. Retirees receive a bonus in their payouts if they worked more than 25 years, and there are various other bonus payments as well. The system is a social pension, as older Ukrainians who did not work or pay into the system still receive pensions. The retirement age is currently 60 for men and 55 for women. The Pension Fund of Ukraine, a quasi-independent body that reports to the Cabinet of Ministers and is managed by a Board with representatives from the government, labor unions, and employers, operates the system.

¶3. Ukraine has a special payroll tax used to fund the pension system. Employers shoulder the greatest burden, paying a 33.2 percent tax on their employees' wages, while workers contribute only 2 percent. (Note: There are also some miscellaneous fees that help fund the pension system, but they are insignificant in comparison to this payroll tax. End Note.) While the payroll tax covers most workers' pensions, the government often must draw on regular budget money to meet shortfalls. The government

also uses normal budget funds to pay for social pensions (i.e. elderly people who did not work) and for some civil service and military pensions.

... For as Long as You Can

¶4. This pay-as-you-go pension system is financially unsustainable in the longer term. Average nominal monthly pensions were UAH 751 in 2008, a 312 percent increase from 2004 and a 57 percent increase from 2007. Pension expenditures grew from 9.6 percent of GDP in 2003 to 15.5 percent in 2008 and are expected to top 17 percent in 2009. The excessively high payroll tax rate for employers, at 33.2 percent, exacerbates shortfalls in financing by encouraging substantial underreporting of wages. A graying population also puts stress on the system; 42 percent of the population in 2008 was 45 years old or older (compared to 37 percent in 1990), and 16 percent was 65 years or older (compared to 12 percent in 1990). The result is a growing need to bolster the system using revenues from the general government budget.

¶5. The current Tymoshenko government exacerbated problems by increasing by 35 percent the accrual rate for retirement payments (i.e. by tinkering with the formula used to determine payments).

Effect on Budget Crisis and Potential Remedies
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¶6. Total Pension Fund outlays in 2008 were UAH 147.9

billion (about $19 billion), equal to 68 percent of all non-pension expenditures of the state budget. Of that 2008 total, UAH 106.5 ($14 billion) was funded by the payroll tax, while UAH 41.4 billion ($5 billion) -- nearly 30 percent of pension outlays and 16 percent of total state budget expenditures -- came from the state budget. (Note: GOU accounting keeps funds provided for pensions through the payroll tax off the books of the state budget. End note.) Of that UAH 41.4 billion that came from the state budget, UAH 36.7 billion went to fund social pensions and civil/military service pensions, and UAH 4.7 billion went to cover shortfalls from the payroll tax for workers' pensions. These figures indicate what an unwieldy beast the pension system has become. Preliminary planning foresees only a modest increase in pension funding from the state budget in 2009 from UAH 41.4 billion to UAH 44.2 billion. The government has not revealed specific estimates of how much will be required to cover payroll tax shortfalls, however, and with the government in the midst of a serious budget crisis (ref A) and payroll tax income expected to fall significantly, outlays to the pension system could break the bank this year.

¶7. The IMF has identified Ukraine's bloated 2009 budget, and the budget gap caused by the pension system in particular, as a chief concern. The GOU's draft 2009 budget envisions a budget deficit of about three percent of GDP. A balanced budget was a key conditionality of the $16.4 billion Stand-By Arrangement, but the IMF has already signaled flexibility, acknowledging that economic situation has deteriorated farther, and faster, than had been expected when the loan was approved last October. While indicating a willingness to accept a certain deficit, the IMF is nonetheless expecting the GOU to address the sizable hole in the budget caused by the deficit at the pension fund.

¶8. The GOU is considering the following measures to reduce pension expenditures:

-- Raising the retirement age to 62 for both men and women;
-- Making it harder to work and receive a pension

simultaneously;
-- Gradually eliminating special pension regimes; and
-- Replacing the flat contribution for farmers and the self-employed with a minimum contribution base.

¶9. While these reforms, especially raising the retirement age, would help reduce expenditures, the potential savings are unlikely to balance the pension system's budget. More aggressive moves, like repealing the recent 35 percent increase in the pension accrual rate, are politically unpalatable, especially with Presidential elections looming on the horizon (see ref B for PM Tymoshenko's recent comments). Moreover, no mere tweaking of pension payments will be enough to provide long-term financial sustainability.

Real Pension Reform: Moving Away from Pay-As-You-Go
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¶10. The key to pension reform is to move away from the pay-as-you-go system. In 2004, Ukraine began a comprehensive reform program envisioning a three-pillar pension system: Pillar I, the pay-as-you-go system; Pillar II, a mandatory accumulation system; and Pillar III, a voluntary private pension system.

¶11. Pillar II, the mandatory accumulation system, is the lynchpin of the reforms and would require all workers to contribute to a pre-funded, individual retirement account, which would eventually be managed by private sector pension funds. Pillar II would reduce the pressure on Pillar I in the long-term and would generate substantial domestic savings to finance economic growth. Pillar II requires that developed capital markets be in place to provide sound investment opportunities, however, and its introduction is therefore not expected before 2011. The government's current fiscal crisis will likely delay introduction of Pillar II even further.

¶12. Pillar III, voluntary private pension funds, actually began operations at the end of 2004. These funds are the only effective, tax-favored method workers have to supplement their retirement income through voluntary

savings. Since 2004 the number of private pension funds has grown rapidly, but they still remain a minor financial actor, with only some 450,000 participants and assets of under $100 million. Pillar III is in a sense a training ground for Pillar II, as it is forcing the GOU to strengthen the legal and regulatory framework for private pension funds and is encouraging consolidation of the private pension fund industry.

Comment: Crisis Inhibitor or Impetus of Reform?
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¶13. Although pressure has been building on the system for years, the current budget crisis will help reveal the weaknesses of the current pension system and argue for reform. Indeed, a USAID project working on pension reform reports that several political figures who previously opposed moving away from pay-as-you-go have now emerged as supporters. On the other hand, however, the necessary pension reforms will cost more in the short-term, as there will be a period of overlap when the government has to fully finance the pay-as-you-go system at the same time that it begins pre-funding the new mandatory accumulation system. In the current atmosphere, there is simply no fiscal space for such reform. End Comment.

TAYLOR